GETTING THE DEAL THROUGH

# Tax on Inbound Investment

## in 30 jurisdictions worldwide 2013

**Contributing editors: Peter Maher and Lew Steinberg**


**Published by *Getting the Deal Through* in association with:**

A&L Goodbody
Anzola Robles & Associates
Berwin Leighton Paisner LLP
BLP Abogados
BMR Legal | BMR Advisors
Boga & Associates
Borden Ladner Gervais LLP
Çağa and Çağa
Carey
Certa Legal Tax
CMS Hasche Sigle
CMS Reich-Rohrwig Hainz
Doria, Jacobina, Rosado e Gondinho Advogados Associados
Hoet Pelaez Castillo & Duque
Iason Skouzos & Partners Law Firm
Juridicon Law Firm
King & Wood Mallesons
KPMG LLP
Mayora & Mayora, SC
Molitor Avocats à la Cour
Nagashima Ohno & Tsunematsu
Poledna Boss Kurer AG
Posse Herrera & Ruiz
Salans
Skeppsbron Skatt AB
Spigt Dutch Caribbean
Tron Abogados, SC
Vieira de Almeida & Associados
Weber Rechtsanwälte GmbH

GETTING THE DEAL THROUGH®

# Tax on Inbound Investment 2013

**Contributing editors**
Peter Maher, A&L Goodbody
Lew Steinberg, Credit Suisse

**Business development managers**
Alan Lee
George Ingledew
Robyn Horsefield
Dan White

**Marketing manager**
Rachel Nurse

**Marketing assistants**
Megan Friedman
Zosia Demkowicz
Cady Atkinson
Robin Synnot

**Admin assistants**
Parween Bains
Sophie Hickey

**Marketing manager (subscriptions)**
Rachel Nurse
*Subscriptions@GettingTheDealThrough.com*

**Assistant editor**
Adam Myers

**Editorial assistant**
Lydia Gerges

**Senior production editor**
Jonathan Cowie

**Chief subeditor**
Jonathan Allen

**Senior subeditor**
Caroline Rawson

**Subeditor**
Anna Andreoli

**Editor-in-chief**
Callum Campbell

**Publisher**
Richard Davey

**Tax on Inbound Investment 2013**
Published by
Law Business Research Ltd
87 Lancaster Road
London, W11 1QQ, UK
Tel: +44 20 7908 1188
Fax: +44 20 7229 6910

ISSN 1753-108X



Printed and distributed by
Encompass Print Solutions
Tel: 0844 2480 112

Law Business Research

## CONTENTS

# Canada

**Stephanie Wong and Richard Eisenbraun**

Borden Ladner Gervais LLP

## Acquisitions (from the buyer's perspective)

### 1 Tax treatment of different acquisitions

What are the differences in tax treatment between an acquisition of stock in a company and the acquisition of business assets and liabilities?

Generally, purchasers prefer to acquire assets, while vendors prefer to sell stock, although the decision to acquire assets or stock in a particular situation will depend on certain facts, including the identity and tax position of the vendor, target and purchaser at the time of the sale; the nature (eg, foreign or domestic, tangible or intangible) and values of the target's assets; and the tax attributes of the target (eg, whether there are any accrued losses).

On a stock acquisition, the purchaser acquires the historic tax liabilities of the target, as well as the historic tax cost of the target's assets (subject to stepping up the cost of certain assets). Assuming that control of the target is acquired, unused capital losses of the target will expire and the use of non-capital losses of the target will be restricted following the acquisition. Periods in which other tax attributes may be utilised may be accelerated, or such attributes may expire or be restricted as to use. Assets that have depreciated in value will have to be written down to their fair market value. The purchaser cannot allocate part of the purchase price of the stock to goodwill. The acquisition of stock is not subject to goods and services tax or to provincial or territorial retail sales tax (or harmonised sales tax). The vendor, however, will have increased flexibility to defer tax depending on the terms of the acquisition.

On an asset acquisition, the purchaser will generally seek the vendor's representation and warranty that no tax liability will attach to the purchased assets. The purchaser's tax cost of a purchased asset will generally equal its allocated purchase price as agreed upon with the vendor, subject to readjustment if the allocation is not reasonable. The purchaser generally may claim tax depreciation on the full cost of depreciable assets acquired and may amortise the cost of goodwill and other intangibles. Goodwill is amortisable as to 75 per cent of its cost on a declining balance basis at the rate of 7 per cent per year. Goods and services tax and provincial or territorial retail sales tax (or harmonised sales tax) are generally levied on the acquisition of assets, as are transfer taxes (if applicable) where real property assets are transferred, unless an exemption applies.

### 2 Step-up in basis

In what circumstances does a purchaser get a step-up in basis in the business assets of the target company? Can goodwill and other intangibles be depreciated for tax purposes in the event of the purchase of those assets, and the purchase of stock in a company owning those assets?

On a stock acquisition, the target company, once acquired, may be amalgamated with, or wound up into, the Canadian acquisition company in certain circumstances to step up or 'bump' the cost of non-depreciable capital property, such as shares of subsidiaries, up to the lesser of the aggregate purchase price and the fair market value of the property on the acquisition date. The rules that permit this bump are intended to preclude a step-up where the vendor or related parties retain, directly or indirectly, assets or an interest in the target. The bump will not apply where the economics are such that the vendor has effected a disguised sale only of certain of the target's assets. The rules have broader application, however, and are extremely complex: for example, the cost of property (including shares) acquired from the Canadian acquisition company or non-arm's-length persons cannot be bumped, thereby preventing the Canadian acquisition company from transferring low-cost, non-depreciable capital property into a subsidiary in advance of the bump. An anti-avoidance rule proposed by the government in 2012 prevents the cost of a partnership interest held by a subsidiary corporation from being bumped on the winding up of the subsidiary (or the amalgamation of the subsidiary and its parent) to the extent that the accrued gain on the partnership interest relates to partnership property that could not be bumped if owned directly by the subsidiary. An acquisition through exchangeable shares or the presence of multiple acquirers may affect entitlement to the bump. Also, structuring an acquisition to achieve a bump may not be warranted in certain circumstances, such as where the target owns significant non-qualifying assets that would substantially reduce the value of the bump.

Upon the acquisition of control of a Canadian target, the target may elect for a deemed disposition of capital property it owns on the change of control, up to a maximum of the property's fair market value. The election allows the target to use capital losses that would otherwise expire on the acquisition of control to offset any capital gain arising from the deemed disposition of capital assets, and results in a step-up in the tax cost of the assets. Unlike the amalgamation or winding-up bump, the acquisition-of-control bump is not restricted to non-depreciable capital property.

A purchaser of assets will have a cost equal to the allocated purchase price of assets acquired and will generally be able to claim tax depreciation on purchased goodwill and intangibles, while a purchaser of stock will not be able to do so.

### 3 Domicile of acquisition company

Is it preferable for an acquisition to be executed by an acquisition company established in or out of your jurisdiction?

A purchaser may decide to use an acquisition company established either inside or outside Canada. The decision will depend on the particular facts, including:

- relative tax rates in the jurisdictions of the purchaser and the target;
- the tax position of the purchaser and the target;
- the existence and terms of any relevant tax treaties; and
- the purchaser's objectives in acquiring the target.

Canada does not restrict returns of capital regardless of whether the distributing corporation has earnings and profits at the time of the distribution. Canada's rate of non-resident withholding tax on dividends is 25 per cent, subject to reduction under an applicable tax treaty. (Dividends are not zero-rated under Canada's tax treaties.) The use of a properly structured Canadian acquisition company will protect the purchaser's rights to repatriate the full amount of its investment as capital without Canadian non-resident withholding tax, subject to the application of foreign affiliate dumping rules proposed by the government in 2012 (see 'Update and trends').

On an asset acquisition, a foreign purchaser will balance the ability to utilise start-up losses to offset its income against the opportunity to defer additional tax on operating profits until distribution.

The use of a Canadian acquisition company may also provide additional flexibility to a Canadian vendor in deferring tax on disposition proceeds.

**4 Company mergers and share exchanges**

Are company mergers or share exchanges common forms of acquisition?

Share exchanges and mergers are common forms of acquisition in Canada either through a takeover bid or plan of arrangement. Plans of arrangement can be used to facilitate more complex transactions and arrangements between the vendor and the purchaser, which may include the delisting of a public company to avoid dividend treatment on a return of capital, the incorporation of assets to facilitate 'bump' planning, extractions of safe income, capital gains exemption planning for Canadian vendors, and reorganisations involving insolvent entities.

Several rollovers provided under the Canadian taxing legislation may permit the vendor to defer Canadian tax on the sale of shares or assets to a Canadian acquisition company.

Subsection 85(1) applies where the acquirer is a taxable Canadian corporation and provides share (or share and non-share) consideration to the vendor in exchange for eligible property (such as shares of the target), and the vendor and the acquirer make a joint election in prescribed form.

Subsection 85.1(1) applies automatically where an acquirer that is a Canadian corporation issues only its own shares from the treasury to the shareholders of the target in exchange for target shares.

An acquisition may also be accomplished through a tax-deferred capital reorganisation of the target under section 86 or a tax-deferred amalgamation of the target with a Canadian acquisition company under section 87.

Where the acquirer is a foreign corporation, Canadian shareholders may exchange their target shares on a tax-deferred basis for special exchangeable shares of a Canadian subsidiary of the foreign acquirer created for this purpose.

Section 116 of the Canadian taxing legislation prescribes reporting procedures that may apply where Canadian target shares are disposed of by a non-resident (see question 16).

**5 Tax benefits in issuing stock**

Is there a tax benefit to the acquirer in issuing stock as consideration rather than cash?

There is no tax benefit to the acquirer in issuing stock as consideration rather than cash. A share-for-share transaction may, however, facilitate a tax deferral on the disposition of a vendor's target shares to a Canadian acquirer. Economically, an acquirer is able to fund an acquisition with less (or no) cash if stock is used.

There may be a tax disadvantage to the acquirer in issuing stock in certain circumstances. For example, the issuance of stock may put the acquirer offside the ineligible property and purchaser rules, thereby disqualifying it from stepping up the tax cost of certain target assets on a post-acquisition amalgamation (or wind-up) bump transaction.

**6 Transaction taxes**

Are documentary taxes payable on the acquisition of stock or business assets and, if so, what are the rates and who is accountable? Are any other transaction taxes payable?

No stamp duties are payable on an acquisition of stock or assets.

A 5 per cent federal goods and services tax (GST) is levied on the fair market value of goods or services supplied in Canada, unless exempted. A stock sale is exempt from GST. An asset sale is generally subject to GST unless:

- the vendor sells a business (or part of a business);
- the acquirer acquires ownership, possession or use of all or substantially all of the property necessary for the purchaser to carry on the business (or part of a business); and
- the vendor and the acquirer file a joint election under the GST legislation.

Most Canadian provinces and territories impose a retail sales tax (RST) or a harmonised sales tax (HST). The tax is levied on the purchaser, consumer or lessee of taxable goods and services in the province or territory. Businesses providing goods or taxable services in a province must obtain a vendor's licence and collect and remit tax on consumer sales. The sale of stock is not subject to RST, while the sale of an asset is generally subject to RST unless specifically exempted.

Some provinces and cities impose a tax on the transfer of real property that is payable generally at the time the transfer is registered, at progressive rates based on the fair market value of the property on the transfer date.

**7 Net operating losses, other tax attributes and insolvency proceedings**

Are net operating losses, tax credits or other types of deferred tax asset subject to any limitations after a change of control of the target or in any other circumstances? If not, are there techniques for preserving them? Are acquisitions or reorganisations of bankrupt or insolvent companies subject to any special rules or tax regimes?

A share acquisition that results in an acquisition of control of a Canadian target (ie, the ownership of a majority of the voting shares of the target, carrying with it the right to elect a majority of the directors of the target) generally has the following tax consequences:

- a taxation year-end is triggered for each of the targets and any controlled Canadian subsidiary;
- undeducted net capital losses and non-capital property losses of the target and each controlled Canadian subsidiary for years preceding the change in control are extinguished and cannot be carried forward post acquisition. Post-acquisition net capital losses and non-capital property losses of the target and each controlled Canadian subsidiary cannot be carried back to years preceding the acquisition of control;
- undeducted non-capital business losses of the target (or controlled Canadian subsidiary) can be carried forward to offset post-acquisition income, and post-acquisition non-capital business losses can be carried back to years preceding the acquisition only if the business of the target (or subsidiary) is carried on with a reasonable expectation of profit throughout the year, and then only to the extent of the income of the target (or subsidiary) from such business or a similar business;
- unused scientific research and development expenses and investment tax credits of the target (or controlled Canadian subsidiary) can be carried forward to a post-acquisition taxation year only if the business of the target (or subsidiary) is carried on with a reasonable expectation of profit throughout the year, and then

only to the extent of the income of the target (or subsidiary) from such business or a similar business; and
- the target and each controlled Canadian subsidiary are deemed to have disposed of certain assets with inherent losses immediately before the acquisition for proceeds equal to their fair market value. Losses realised are subject to the foregoing restrictions. The target may elect for a deemed disposition of its appreciated capital property to offset realised losses and step up the tax cost of the assets on the acquisition of control.

When a Canadian corporation becomes bankrupt, a taxation year-end will be triggered, accelerating the expiry period of any time-limited tax attributes, such as unused non-capital losses (which currently can be carried forward for 20 years subject to acquisition-of-control restrictions). For a taxation year in which a corporation is bankrupt, the corporation is deemed not to be associated with any other corporation for the purposes of determining its entitlement to certain tax incentives. A bankrupt corporation is also not subject to the debt forgiveness rules. Corporations in financial difficulty may be permitted in specified circumstances to refinance an existing loan by issuing tax-advantaged preferred shares to reduce borrowing costs without triggering debt forgiveness.

Acquisitions or reorganisations of bankrupt or insolvent companies are not subject to any other special rules or tax regimes. Insolvent companies often have substantial tax attributes, however, so careful consideration should be given to the extent to which those attributes can be preserved or efficiently utilised.

### 8 Interest relief

Does an acquisition company get interest relief for borrowings to acquire the target? Are there restrictions on deductibility where the lender is foreign, a related party, or both? Can withholding taxes on interest payments be easily avoided? Is debt pushdown easily achieved? In particular, are there capitalisation rules that prevent the pushdown of excessive debt?

Subject to certain restrictions, a Canadian acquisition company may deduct simple interest on borrowed money used to acquire a Canadian target in computing its income for a taxation year. Since the Canadian tax system does not permit consolidation, however, the Canadian acquisition company generally must ensure that it has sufficient income (other than inter-corporate dividends, which are not taxable) to use the deduction. Debt push-down strategies are generally permitted, and are used to match the interest expense against the operating income of the target or its subsidiaries.

Interest will generally be deductible if the following requirements are met:
- the amount meets the legal criteria of 'interest';
- there is a legal obligation pursuant to which the interest is paid in the year or payable in respect of the year (in contrast to simple interest, compound interest is deductible only when paid);
- the borrowed funds or the obligation on which the interest is payable are used for one of several eligible uses, such as borrowings, or an amount payable for property acquired, for the purpose of earning income from a business or property (other than exempt income or income from an insurance policy). Eligible uses of borrowed funds include the payment of dividends (within certain limits), the return of capital to shareholders, the provision of working capital and the acquisition of assets for use in the business; and
- the amount must be reasonable (generally, an arm's-length interest rate should be reasonable).

Where the lender is a foreign related party, thin capitalisation rules impose restrictions on interest deductibility. Currently, the thin capitalisation rules apply to Canadian resident corporations in respect of amounts owing to a non-resident shareholder (a 'specified shareholder') who, either alone or with non-arm's-length persons, holds 25 per cent or more of the total votes or fair market value of all of the Canadian corporation's shares. Where the debt-to-equity ratio of the Canadian corporation is more than 2:1, the deduction of interest paid on the excessive debt owing to non-arm's-length non-residents is denied. Pursuant to amendments proposed by the government in 2012, the thin capitalisation rules have been extended to debts owed by partnerships of which a Canadian resident corporation is a member and the debtor is a non-resident specified shareholder of the Canadian corporate partner. If a corporate partner's permitted debt-to-equity ratio is exceeded, the partnership's interest deduction is not denied, but an amount must be included in computing the corporate partner's income. The denied interest (or required income inclusion) is recharacterised as a dividend for Canadian non-resident withholding tax purposes and is subject to withholding tax at a rate of 25 per cent (unless reduced under an applicable tax treaty). Also, beginning in 2013, the permitted debt-to-equity ratio will be reduced to 1.5:1.

Under section 78 of the Canadian taxing legislation, where a Canadian borrower deducts interest expense payable to a non-arm's-length person in computing its income for a taxation year, but does not actually pay the amount within a specified period, the unpaid amount generally must be included in computing the borrower's income in the later year.

Canada's domestic interest withholding tax exemption applies to cross-border interest payments where the interest is either fully exempt interest or is non-participating debt interest paid to an arm's-length person. In response to the Federal Court of Appeal decision in *Lehigh Cement v The Queen*, the Canadian government proposed to amend the withholding tax rules, effective as of 16 March 2011, to ensure that withholding tax applies (subject to the application of Canada's tax treaties) to interest paid or credited by a Canadian resident to an arm's-length non-resident person in respect of debt where the principal amount of the debt is owed to a non-arm's-length non-resident.

On 20 July 2011, the Canadian government announced proposed legislative amendments, effective as of that date, to eliminate the tax advantages associated with certain publicly traded stapled securities structures by denying the issuer an interest deduction for interest paid on stapled debt.

On 19 August 2011, the Canadian government released for public consultation legislative proposals including a new upstream loan rule, applicable after that date, which includes in a Canadian taxpayer's income, subject to certain exceptions, the amount of a loan made by a foreign affiliate to the taxpayer or to a person not dealing at arm's length with the taxpayer (except a controlled foreign affiliate) where the loan remains outstanding for more than two years.

### 9 Protections for acquisitions

What forms of protection are generally sought for stock and business asset acquisitions? How are they documented? How are any payments made following a claim under a warranty or indemnity treated from a tax perspective? Are they subject to withholding taxes or taxable in the hands of the recipient?

The acquirer will generally require the vendor to provide detailed tax representations and warranties, tax covenants and tax indemnities in the legal documentation for a stock or asset acquisition. More detailed tax representations and warranties are generally sought in the context of a stock purchase rather than an asset purchase since the purchaser will acquire the historic tax liabilities of the target. The purchaser generally will request the vendor to warrant that it is not a non-resident of Canada or, if the vendor is a non-resident, may require the vendor to comply with applicable reporting procedures under section 116 of the Canadian taxing legislation before allowing the full sale proceeds to be released. The vendor generally will also provide a tax indemnity to the purchaser for the vendor's breach of

any tax representation or warranty, subject to specified monetary and timing thresholds.

On a stock acquisition, common tax representations, warranties and covenants of the vendor or target include the due filing and accuracy of all of the target's financial statements and tax returns, and the due payment by the target of all relevant taxes and required withholdings and remittances.

On an asset acquisition, common tax representations and warranties of the vendor or target focus on ensuring that the target has no outstanding tax liabilities or withholding and remittance obligations that may result in a lien or encumbrance on, or a claim against, the purchased assets. The vendor will also generally warrant that no tax election or designation has been made in respect of the purchased assets that would affect the purchaser's tax treatment of the purchased assets.

The tax treatment of a payment under a warranty or indemnity will depend on how it is paid (eg, as an adjustment of the purchase price or a reimbursement of costs). Canadian non-resident withholding tax generally would not apply to a payment under a warranty or indemnity except to the extent that a portion represents interest that is not exempt from withholding tax (see question 8).

## Post-acquisition planning

### 10 Restructuring

What post-acquisition restructuring, if any, is typically carried out and why?

Anti-avoidance rules in the Canadian taxing legislation prevent a foreign acquirer from increasing the paid-up capital of stock in a related Canadian corporation post-acquisition.

The following types of restructuring may be carried out post-acquisition:

- conversion of corporate entities to fiscally transparent entities such as partnerships;
- consolidation planning to combine losses with profitable businesses;
- elimination of exchangeable shares issued on the acquisition;
- delisting of an acquired public company to eliminate deemed dividend treatment for returns of capital; and
- divestment of non-core assets or businesses.

In carrying out any post-acquisition restructuring that results in tax deferrals or tax benefits, as defined in the Canadian taxing legislation, the potential application of specific anti-avoidance provisions and Canada's general anti-avoidance rule (GAAR) must be considered. In *Copthorne Holdings Ltd v The Queen*, a recent Supreme Court of Canada decision, the government successfully challenged a corporate reorganisation transaction that increased the paid-up capital of a foreign shareholder's stock in a related Canadian corporation.

### 11 Spin-offs

Can tax neutral spin-offs of businesses be executed and, if so, can the net operating losses of the spun-off business be preserved? Is it possible to achieve a spin-off without triggering transfer taxes?

Tax neutral spin-offs of subsidiaries or business assets may be carried out in Canada. However, Canada prohibits arrangements that are structured to use the general inter-corporate dividend deduction to reduce a capital gain that would otherwise be realised on a disposition of corporate stock. The spin-off rules provide two narrow exceptions to that prohibition.

The first type of permitted tax deferred spin-off allows corporate property to be distributed by way of dividend within a related group of companies. Detailed rules prohibit the disposition of property to an unrelated person as part of a series of transactions or events in which the dividend is received and provide special rules for determining whether persons are related.

The second type of spin-off, known as a 'butterfly', permits types of corporate property (generally cash, business property and investment property) to be distributed by way of dividend on a pro rata basis to a corporation's shareholders. The rules relating to the second type of spin-off are very complex and, among other things, prohibit certain transfers, dispositions and other transactions from taking place as part of the series of transactions in which the corporate property is distributed to the shareholders.

Where a business has net operating losses, this might complicate the spin-off process. Net operating losses will generally not follow the spun-off business.

Transfer taxes such as GST or HST, provincial sales taxes in Saskatchewan, Manitoba and Prince Edward Island, and land transfer tax may apply where corporate property is distributed to a corporation's shareholders. Where corporate property is distributed as a dividend in kind to a corporation's shareholders, GST or HST will generally apply on the fair market value of the property distributed. Likewise, provincial sales taxes in Saskatchewan, Manitoba and Prince Edward Island may apply on a transfer of property from a corporation to its shareholders to the extent that a specific exemption is not available. Where real property (land, buildings, etc) is distributed to the shareholders in a spin-off, provincial and municipal land transfer taxes may apply. In some circumstances, exemptions may be available from some or all of these taxes in the context of related-party transactions. Elections may also be available in certain circumstances to defer or avoid these taxes.

### 12 Migration of residence

Is it possible to migrate the residence of the acquisition company or target company from your jurisdiction without tax consequences?

Generally, the residence of a Canadian acquisition or target company cannot be migrated from Canada without Canadian tax consequences. Canada imposes a departure tax. Special Canadian tax rules impose a departure tax on a corporation that ceases to be resident in Canada by deeming it to have disposed of all of its assets immediately prior to the emigration for their fair market value at that time and to have immediately reacquired the assets for the same amount. The corporation must then include in computing its income for the taxation year ending on emigration any capital or income gains realised on the deemed disposition of the assets and pay corporate tax on the resulting net gains at regular corporate tax rates. In addition, the corporation is required to pay, for its taxation year ending on emigration, a tax generally equal to 25 per cent of the amount by which the fair market value of all of its property exceeds the total of the paid-up capital of its shares and its outstanding debts and other amounts owing, but the rate is subject to reduction under an applicable tax treaty between Canada and the jurisdiction of emigration.

Generally, a corporation is deemed to be a resident of Canada if it was incorporated in Canada after 26 April 1965. A corporation incorporated in Canada that is continued to a jurisdiction outside Canada is deemed to be a non-resident of Canada from the continuation date.

A corporation incorporated outside Canada is considered to be resident in Canada for a taxation year if its central management and control was located in Canada, namely the corporation's directors (or such other persons having the legal power to manage and control the corporation) exercised management and control in Canada. If, however, a corporation would otherwise be resident in Canada under domestic rules but is considered to be resident in another country under an applicable Canadian bilateral tax treaty, then the corporation generally is deemed not to be resident in Canada for Canadian tax purposes.

**13 Interest and dividend payments**

Are interest and dividend payments made out of your jurisdiction subject to withholding taxes and, if so, at what rates? Are there domestic exemptions from these withholdings or are they treaty-dependent?

Dividends paid or credited (or deemed paid or credited) to non-residents of Canada are subject to domestic Canadian non-resident withholding tax at the rate of 25 per cent, which may be reduced under an applicable tax treaty. Many of Canada's tax treaties, including the Canada–US Income Tax Convention, reduce the 25 per cent domestic rate to 15 per cent on dividends, with a further reduction to 5 per cent where the beneficial owner of the dividends is a corporation entitled to treaty benefits and owns at least 10 per cent of the voting shares of the Canadian corporation paying the dividends.

Canada does not levy Canadian non-resident withholding tax on interest paid or credited (or deemed paid or credited) to non-residents of Canada, except on interest that is not 'fully exempt interest' and is paid to, or in respect of a debt owing to, a non-arm's-length person; or on interest that is 'participating debt interest'.

'Fully exempt interest' is generally interest on debt obligations issued by government or quasi-government entities and certain tax-exempt organisations; mortgages in respect of real property situated outside of Canada (except where the interest on the mortgage is deductible in computing income in Canada); debt obligations issued by certain international organisations; and qualifying securities lending arrangements.

'Participating debt interest' is generally interest that is paid or payable on an obligation, all or any portion of which is contingent or dependent on the use of or production from property in Canada or is computed by reference to either revenue, profit, cash flow, commodity price or any other similar criterion; or dividends paid or payable to shareholders of any class of shares of the capital stock of any corporation. The broad meaning of participating debt interest, combined with the potential application of certain domestic deeming rules, raises issues as to the application of non-resident withholding tax in respect of interest paid on certain debt instruments (convertible or exchangeable debt).

The withholding tax exemption extends to certain payments, including stand-by, commitment and guarantee fees (which are assimilated to interest for Canadian tax purposes), provided that the recipient deals at arm's length with the borrower and the amounts are not participating debt interest.

Non-exempt interest may be eligible for an exemption or rate reduction (in many cases to 10 per cent) under an applicable tax treaty between Canada and the recipient's country of residence. The Canada–US Income Tax Convention has fully phased out withholding tax on related-party interest payments (except participating interest) between US and Canadian residents from 1 January 2010, provided that the payee is entitled to treaty benefits under the limitation-on-benefits provisions, and the interest rate charged does not exceed the rate that would be agreed upon by non-related persons. Excess interest payments and participating interest will generally qualify for a reduced withholding rate of 15 per cent under the treaty.

**14 Tax-efficient extraction of profits**

What other tax-efficient means are adopted for extracting profits from your jurisdiction?

Non-resident investors will prefer to redeploy rather than repatriate Canadian profits if they are taxable on dividend receipts and unable to receive full foreign tax credits for foreign taxes paid in their residence country. No Canadian tax treaty exempts dividends from Canadian non-resident withholding tax, thereby increasing the cost of repatriation to non-resident investors. Canadian profits have been used in the past by foreign shareholders, through downstream lending arrangements, to fund foreign affiliates. Opportunities for structuring such arrangements have been limited considerably in recent years. The purchase of assets or investments from related non-resident corporations by a Canadian subsidiary may still be viable in certain circumstances, subject to new foreign tax credit generator proposals initiated by Canada in early 2010 (which have not yet been enacted) and new foreign affiliate dumping rules proposed in 2012 (see 'Update and trends'). In the context of Canada–US planning, hybrid entities may still be used in certain circumstances, and hybrid instruments may be available to structure debt for Canadian tax purposes that will be considered to be equity for US tax purposes.

Capital may be returned by a Canadian private corporation to a non-resident shareholder without Canadian non-resident withholding tax as long as payments do not exceed the paid-up capital of the shares for tax purposes. Rules in the Canadian taxing legislation may limit or reduce the paid-up capital of shares in certain circumstances. Any excess amount returned to the shareholder is deemed to be a dividend subject to Canadian non-resident withholding tax at the 25 per cent domestic rate (unless reduced under an applicable tax treaty). The shareholder's tax cost of its shares will be reduced by the amount returned, thereby reducing the Canadian corporation's calculation of equity under the thin capitalisation rules.

Often overlooked, if a Canadian public corporation reduces the paid-up capital in respect of any class of its shares other than by way of a redemption, acquisition or cancellation of shares, or a winding-up or reorganisation that meets specified requirements, the full amount of the reduction is deemed to be a dividend subject to withholding tax, as described above.

Subject to domestic transfer pricing rules, a Canadian subsidiary may pay tax-deductible royalties or management fees to its non-resident shareholder where circumstances warrant.

Royalties paid or credited to a non-resident are generally subject to withholding tax at the 25 per cent domestic rate, unless exempted or the rate is reduced under an applicable tax treaty. Domestic exemptions from withholding tax include payments in respect of the production or reproduction of computer software and payments made under a bona fide cost-sharing arrangement meeting specified requirements. Some of Canada's tax treaties, such as the Canada–US Income Tax Convention, reduce the withholding tax rate to 10 per cent and also exempt from withholding tax a payment for the use of, or the right to use, a patent; information concerning industrial, commercial or scientific experience; or computer software.

Management fees paid or credited to a non-arm's-length non-resident will be exempted from the 25 per cent domestic rate of withholding tax under certain tax treaties, such as the Canada–US Income Tax Convention, if they are considered to be business profits under the treaty and are not attributable to a business carried on by the non-resident in Canada through a permanent establishment.

Loans made to, or indebtedness owing by, a non-resident shareholder are generally deemed to be a dividend and subject to withholding tax at the 25 per cent domestic rate (unless reduced under an applicable tax treaty). There is generally an exception to this rule for a loan or indebtedness repaid within one year after the end of the taxation year in which the loan was made or the indebtedness was incurred, but only if the repayment is not part of a series of loans or indebtedness and repayments.

## Disposals (from the seller's perspective)

**15 Disposals**

How are disposals most commonly carried out – a disposal of the business assets, the stock in the local company or stock in the foreign holding company?

A vendor generally will prefer to sell stock, but in certain situations factors such as the tax attributes (or a decline in value) of the assets or shares may shift the vendor's preference towards selling assets.

A non-resident vendor holding stock of a Canadian corporation as capital property will generally prefer to sell stock rather than assets where the capital gain arising on the stock sale is exempt from

**Update and trends**

In 2012, the Canadian government introduced several amendments to Canada's thin capitalisation rules (see question 8).

The government has also proposed broad new rules to take aim at 'foreign affiliate dumping' involving Canadian subsidiaries of foreign parent corporations. Generally, the rules target transactions where a Canadian resident corporation controlled by a foreign parent acquires shares of another foreign group member by issuing its own shares to the parent or incurring debt. Prior to the new rules, the share issuance would generally increase the paid-up capital of the shares of the Canadian subsidiary held by the parent, thus increasing the amount that could be returned to the parent on a tax-free basis (instead of as a dividend subject to withholding tax). The incurrence of debt would enable the Canadian subsidiary to deduct interest expense while receiving tax-exempt dividends on the foreign affiliate shares held by it. Subject to certain exceptions (including a business purpose exception intended to preserve the ability of Canadian subsidiaries to undertake legitimate expansion of their Canadian-based businesses), the new rules would deny the paid-up capital increase that would otherwise occur on such share issuance, or deem a dividend to have been paid to the foreign parent equal to the value of any properties transferred, obligations assumed or incurred, or benefits otherwise conferred by the Canadian subsidiary. The new rules apply to transactions occurring after 28 March 2012, and exclude transactions that occur before 2013 between parties that deal at arm's length and that are obliged to complete the transaction pursuant to the terms of an agreement in writing entered into before 29 March 2012.

Draft legislation to implement the new rules was released by the government on 14 August 2012.

In recent years, the Canadian government has been aggressive in challenging taxpayers on transfer pricing, and various transfer pricing matters are currently under audit or before the courts. In 2012, the Supreme Court of Canada heard its first transfer pricing case, and its decision is pending. The government also proposed legislative amendments to clarify that, in certain circumstances, a benefit arising from a transfer pricing adjustment will be treated as a deemed dividend to the non-resident participant and be subject to withholding tax at a rate of 25 per cent (unless reduced under an applicable tax treaty).

In the 2012 case of *Velcro Canada Inc v The Queen*, the government was again unsuccessful in challenging the entitlement of a Dutch intermediary holding company to the benefit of a treaty-reduced rate of Canadian withholding tax under the Canada–Netherlands Income Tax Convention, based on the argument that it was not the beneficial owner of the payments received. The Dutch holding company was assigned royalty and payment rights under a licence agreement between an affiliated licensor and the Canadian taxpayer, and was contractually obliged to pay 90 per cent of the royalty payments it received from the Canadian taxpayer to the affiliated licensor. The Tax Court concluded that the Dutch holding company beneficially owned the royalties since it met the definition of beneficial ownership developed in the earlier case of *Prévost Car* by having possession, use and risk of, and control over, the royalties. Furthermore, the Tax Court held that the Dutch holding company was not a conduit, as it had some discretion regarding the use of the royalty payments.

Canadian tax under an applicable tax treaty between Canada and the vendor's country of residence. In certain cases, a non-resident vendor may realise benefits by selling the stock of a foreign holding company where a tax treaty may not otherwise provide an exemption on the sale of Canadian corporate stock directly. A disposal of the foreign holding company stock, however, may be taxable in Canada if at any time in the 60-month period prior to the disposal more than 50 per cent of the stock's fair market value was derived from one or any combination of real or immoveable property situated in Canada, Canadian resource properties, timber resource properties or options or interests in any of the foregoing property.

On an asset sale, careful consideration should be given to the allocation of the sale price among the various assets being sold. Furthermore, the Federal Court of Appeal recently ruled in *Daishowa-Marubeni International Ltd v The Queen* that the value of liabilities connected to a property sold by the vendor should be included in the sale proceeds for tax purposes. This case has been appealed to the Supreme Court of Canada and is expected to be heard in 2013.

**16 Disposals of stock**

Where the disposal is of stock in the local company by a non-resident company, will gains on disposal be exempt from tax? Are there special rules dealing with the disposal of stock in real property, energy and natural resource companies?

The Canadian rules with regard to the taxation of foreign vendors disposing of stock in a listed or unlisted corporation, as well as the consequent reporting and withholding requirements, are generally consistent with Canada's tax treaties. Generally, Canada's domestic legislation will seek to tax a non-resident on the disposition of the stock of a Canadian company either where the non-resident uses or holds (or is deemed to use or hold) the stock in carrying on a business in Canada or where the stock is (or is deemed to be) taxable Canadian property for Canadian tax purposes. Where a non-resident vendor sells an asset that is excluded from the definition of taxable Canadian property, the vendor is not required to report or file a Canadian tax return in respect of the disposition.

Under the definition of taxable Canadian property, a share of the capital stock of a corporation (other than a mutual fund corporation) that is not listed on a designated stock exchange will be taxable Canadian property if, at any time during the 60-month period prior to the disposition of the share, more than 50 per cent of the fair market value of the share was derived directly or indirectly from one or any combination of real or immoveable property situated in Canada, Canadian resource properties, timber resource properties and options or interests in any of the foregoing property. A share of the capital stock of a corporation that is listed on a designated stock exchange will be taxable Canadian property if, at any time during the 60-month period prior to the disposition of the share, the vendor, either alone or together with non-arm's-length persons, owned 25 per cent or more of the issued shares of any class of the capital stock of the corporation and more than 50 per cent of the fair market value of the share was derived directly or indirectly from one or any combination of real or immoveable property situated in Canada, Canadian resource properties, timber resource properties and options or interests in any of the foregoing property.

Net taxable capital gains (generally 50 per cent of total capital gains minus 50 per cent of total capital losses) of a non-resident from the disposition of taxable Canadian property are subject to tax in Canada. Many of Canada's treaties include exemptions for dispositions of shares, however, except where those shares derive their value principally from underlying real property situated in Canada; see, for example, the Canada–US Income Tax Convention. Canada's Income Tax Conventions Interpretation Act defines real property for the purposes of Canada's tax treaties to include any right to explore for or exploit, or any right to an amount computed by reference to the production or to the value of production from, mineral deposits and sources and other natural resources in Canada.

Dispositions of non-excluded taxable Canadian property are generally subject to reporting requirements under section 116 of the Canadian taxing legislation, except where a tax treaty between Canada and the non-resident's country of residence exempts the disposition from Canadian tax. The non-resident generally must file a Canadian tax return and claim an applicable treaty exemption from Canadian tax.

However, a non-resident is exempted from filing a tax return if it has no Canadian tax payable for the taxation year, no outstanding Canadian tax liability for a previous year, and either the property is excluded from the section 116 reporting or a section 116 certificate has been issued in respect of the property. As the filing exemption requires a purchaser to assess these factors effectively and, if incorrect, to be financially accountable, it is unlikely that purchasers in arm's-length transactions will proceed without the reporting.

**17 Avoiding and deferring tax**

If a gain is taxable on the disposal either of the shares in the local company or of the business assets by the local company, are there any methods for deferring or avoiding the tax?

Several rollovers provided under the Canadian taxing legislation may permit a Canadian vendor to defer tax on the disposition of shares or assets to a Canadian corporation for shares. No rollover is available for the transfer of the shares or business assets of a Canadian corporation to a non-resident. However, an exchangeable share transaction may enable Canadian shareholders to exchange their target shares on a deferred tax basis for shares of another Canadian corporation exchangeable for common shares of the foreign acquirer. The exchangeable shares generally have the same economic attributes as the shares of the acquirer. Exchangeable share structures are used because there is currently no rollover available to a Canadian vendor for an exchange of Canadian target shares for shares of a foreign acquirer. Canadian vendors may in certain circumstances benefit from a deferral on the exchange of foreign target shares for shares of a foreign acquirer.

Capital gains stripping rules generally prevent the payment of a tax-free inter-corporate dividend from the target to its Canadian parent to reduce the capital gain on the sale of the target's shares. Previously taxed income of the target may generally be extracted tax-free prior to the sale, however, provided certain requirements are met.

Other specific anti-avoidance rules may require consideration. Also, GAAR (Canada's general anti-avoidance rule) will apply to an 'avoidance transaction' that results in a tax benefit, unless it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the Canadian taxing legislation or a Canadian tax treaty. An 'avoidance transaction' is a transaction (or part of a series of transactions) that would result in a tax benefit (a reduction, avoidance or deferral of tax), unless the transaction has been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit. If the GAAR applies, the Canadian taxing authorities may redetermine the tax consequences to the person as is reasonable in the circumstances to deny the tax benefit.

Following similar initiatives by the United States, the United Kingdom, Australia and the province of Quebec, Canada has introduced a regime of mandatory disclosure generally applicable to certain tax avoidance transactions entered into after 2010. An avoidance transaction, as defined under the GAAR, must be reported to the Canadian taxation authorities where two out of three specific hallmarks apply. Draft legislation implementing the regime has been released but has not yet been enacted.


# Borden Ladner Gervais LLP

**Stephanie Wong** **swong@blg.com**
**Richard Eisenbraun** **reisenbraun@blg.com**

Scotia Plaza
40 King Street West
Toronto
Ontario M5H 3Y4
Canada
Tel: +1 416 367 6000
Fax: +1 416 367 6749
www.blg.com

Centennial Place, East Tower
1900, 520 – 3rd Ave SW
Calgary
Alberta T2P 0R3
Canada
Tel: +1 403 232 9500
Fax: +1 403 266 1395

TAX ON INBOUND INVESTMENT 2013 ISSN 1753-108X